RICHARD RUSSELL'S **DOW THEORY LETTERS, INC.**

P.O. Box 1759, La Jolla, California 92038
36 Letters per year — $150 Annually
Registered with the Securities and Exchange Commission

November 30, 1977 **LETTER 715**

Nov. 18, DJIA 837.76; PTI 792; A-D Ratio –20.15
Nov. 25, DJIA 844.42; PTI 816; A-D Ratio –19.28

THE MARKET: As I've stated dozens of times, the market will always do what it has to—to fool and confuse the greatest number of people. A corollary to this is as follows: the market hates winners, and it will do whatever it has to—to part the investor from his money.

Following the terrible bear market smash of 1973-74, the ranks of the so-called market technicians filled up. They filled up because only the technical approach had given warning of the disaster which was to befall investors. Ah, says Wall Street, now that we have all these newly-converted amateur technicians, how do we destroy the credibility of "the new crop," how do we bring them to their knees? Simple, says Wall Street, we **switch the signals.**

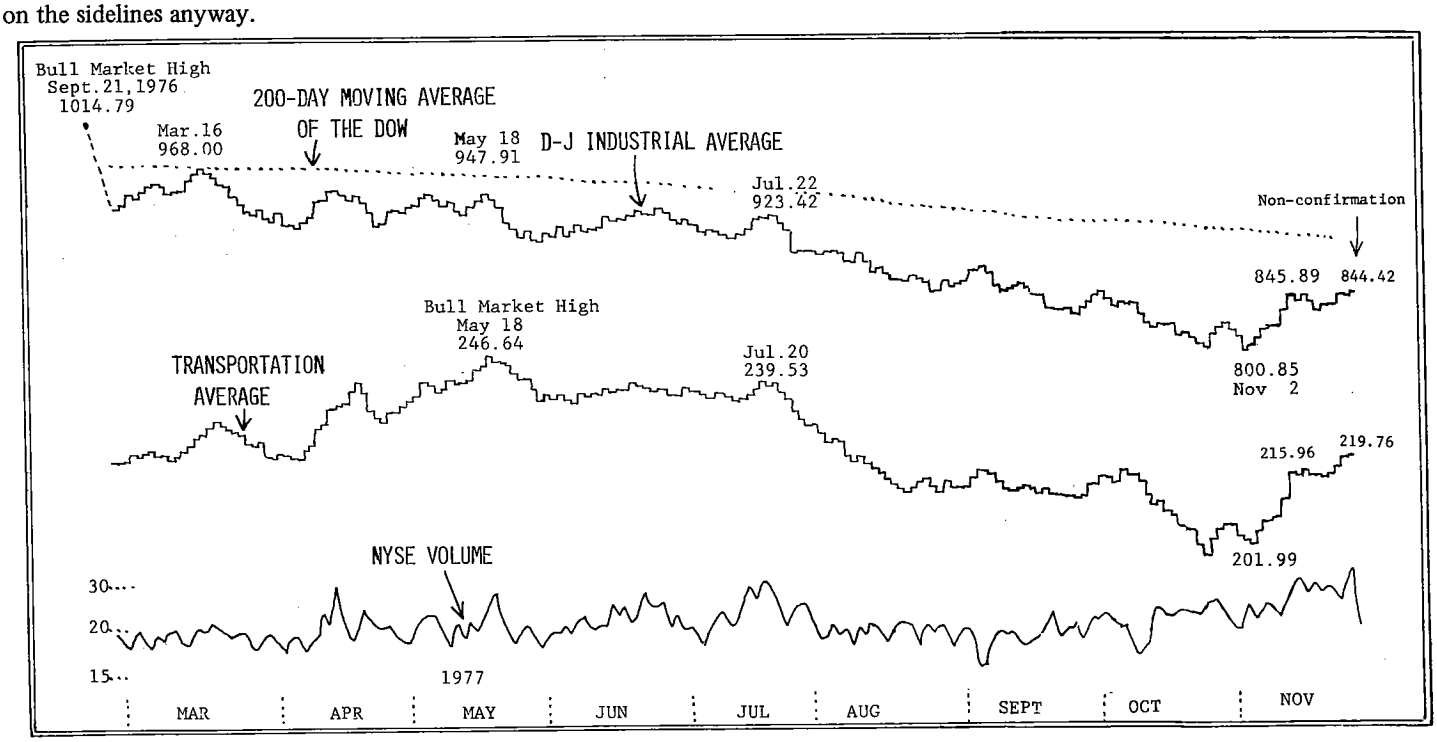
I discussed in Letter 713 (page 1) how the traditional market signals were reversed in 1976 and 1977. For instance, "normally" we have a progression wherein the Bonds, the Utilities and the Advance-Decline ratio top out—**followed** by the Dow. That's the way it always works. But not so in 1976-77. Here's what happened. We saw the Dow top out in September, 1976. The Transports hit their peak in May, 1977. In July the A-D ratio and the Utilities topped out. And just for good measure, the S&P 500 Stock Average topped out in September.

Nor did the Dow Theory make it easy for those who insisted that everything has to follow the rules on Wall Street. On October 24 (8 months after the Industrials break) the Transports finally confirmed the bearish indications of the Dow. In so doing, the Averages told us that we had seen a bear market decline during 1977, not a bull market correction. The difference to readers of these Letters was academic, since we were on the sidelines anyway.

All of which brings us to the present. The traditionalists reason that since the Dow has been down all year, we must currently be seeing the start of a major upward advance (or at least an extended year-end rally). Now I have nothing against year-end rallies; I happen to think they're delightful. But whether we have to have a big explosion into the end of the year is something else again. True, so far in 1977 we've had only one measly 5% rally in the Dow. And we deserve a lot better than that. But since the action of the market all during 1977 has been non-traditional and therefore disappointing and deceptive, it occurs to me that there could be more disappointments for the traditionals before the year is out.

My old friend Joe Granville (as shrewd an analyst as I have known) makes a most interesting point in his latest report. Joe notes that "*One has to think now in psychological terms of the winners and losers in this game.*" He notes that most analysts have been bullish and therefore very wrong on this market all during 1977. Joe continues, "*A bear couldn't care less if the market ever bottomed out. A bull, who has been wrong all year, WANTS THE MARKET TO BOTTOM OUT . . . In fact, he has to have a bottom to survive.*" And as I've said before, the market isn't interested in survivors, it's interested in beating us—all of us, if it can!

Obviously, I can't present a blueprint on what is coming up. But it does seem to me that potential shockers ahead could be (1) little or no further "year-end rally" for 1977, (2) a new decline taking the Dow and most stocks well below the recent lows, and (3) a belated lesson for those who derided Dow's Theory in the form of one or more major legs down below the Dow 800 level.



On a cold reading of the Averages, an Industrial bettering of **845.89** (confirmed with a rising Transportation Average) would point the way to higher prices and an extension of the rally. At this writing, however, Industrials have not confirmed the recovery highs of the Transports, and as far as Dow's Theory is concerned, we have been watching a high-volume non-confirmation–often a sign of distribution. **The 845.89 Industrials point seems to be the key.** If Industrials better that point we'll have more upside push, while a continued failure to better 845.89 will be quite bearish.

* *

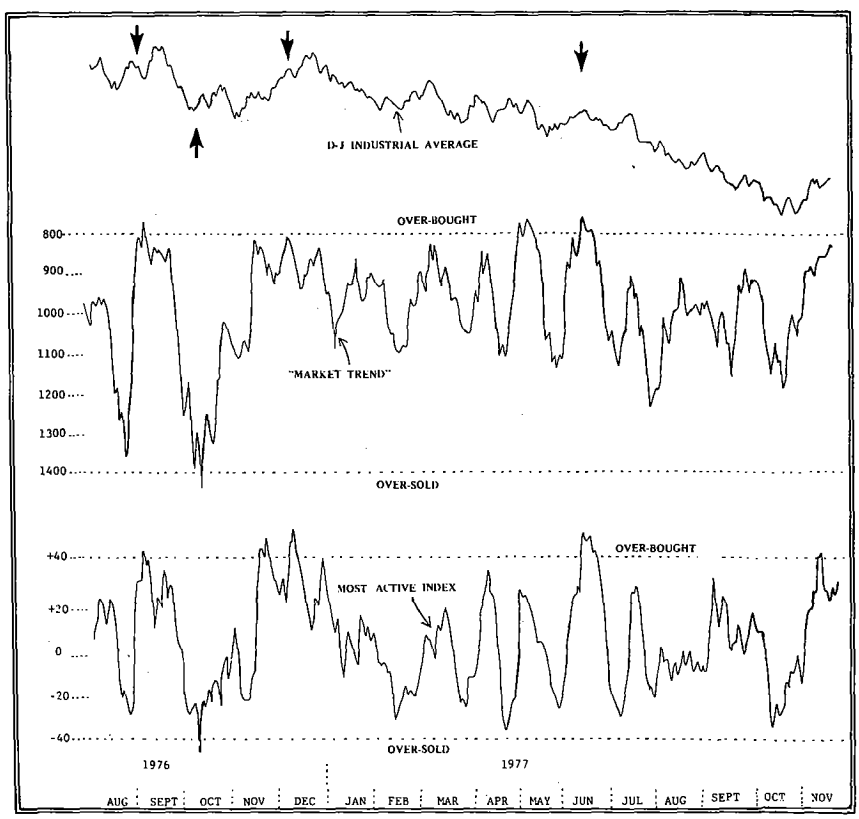
The moving averages of the Dow are still not positive. The 4-week MA is at 827, 9 points below the 13-week MA, which is at 836. If the 4-week MA rises above the 13-week we would have a "buy alert." The 13-week MA at 836 is 70 points below the 50-week which is at 906. The major buy signal occurs when the 13 rises above the 50-week. The 13 and 50 week spread closed by 2 points this week, a faint hopeful sign for sometime in 1978.

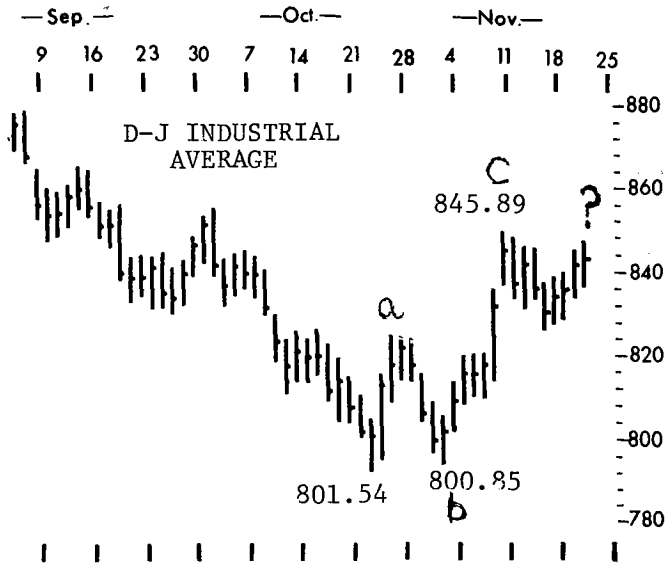
* *

The near-term overbought and over-sold indicators are still bouncing around in what I would call semi-over-bought territory. Greatest safety in buying always comes when purchases are made in the over-sold territory. These two indicators are always to be viewed *together*. At no time since June, 1977 (arrow on chart) have we seen a full over-sold or full over-bought situation. But right now, the market is *straining* on the upside.

* *

Odd-lot short sellers (traditionally the wrongest group in the market) are again betting that there's no money to be made on the downside. Odd-lot shorts have dropped below 1,000 on 3 of the last 5 trading days, and that's mighty little shorting (for instance, sometimes a year or more will go by with no "under-1,000" day of odd-lot shorts).





FIBONACCI: By the time you read this it is possible that Industrials will have bettered the 845.89 point, and, in that case, this study will be meaningless. Nevertheless, I thought the following was interesting in the light of my Fibonacci studies. I will just briefly state that the "Fibonacci series" is a mathematical series which is derived by adding the previous two numbers together to produce the third. Thus 1 and 1 is 2, 2 and 1 is **3**, 3 and 2 is **5**, 5 and 3 is **8**, and so on to 13, 21, 34, 55, 89, etc. This series is found extensively in nature and is an integral part of the Elliott Wave studies.

In the last Letter (page 3) I showed how, according to my Elliott count, major declining Wave III terminated for the Dow at 801.54 on October 25, 1977. Since then the Dow has been in (upward) corrective Wave IV. I show part (or conceivably all) of Wave IV on this chart from the *Wall Street Journal*. From the start of Wave IV at 801.54 on Oct. 25 to point C on November 11 is exactly **13** days. Now the Dow peak at C is 845.89. If you add up each number of 845.89 you get **34**. Finally, the Dow rise from 800.85 to the peak at C of 845.89 represents a correction of exactly **21%** of the entire 1976-77 drop in the Dow (from 1014.79 to 800.85).

Thus, we have three Fibonacci numbers which come up in connection with the recent October-November rally, the three numbers being 13, 21, and 34. That tells me that the 845.89 peak at C was quite important. It suggests (if the market turns down with the Dow having failed to better 845.89) that we may have seen the end of a rather short correction. If so (and I obviously can't tell at this writing), we could have a rather large leg V down. Abbreviated upward corrections often lead to extensive declines.

RELATIVE STRENGTH: I keep a number of relative strength charts, not only of individual stocks and stock groups, but of broad *group* classifications. In each case the price of the group is divided by a broad stock average, and a ratio is thereby obtained. When plotted, these relative strength ratios often provide us with interesting and profitable information.

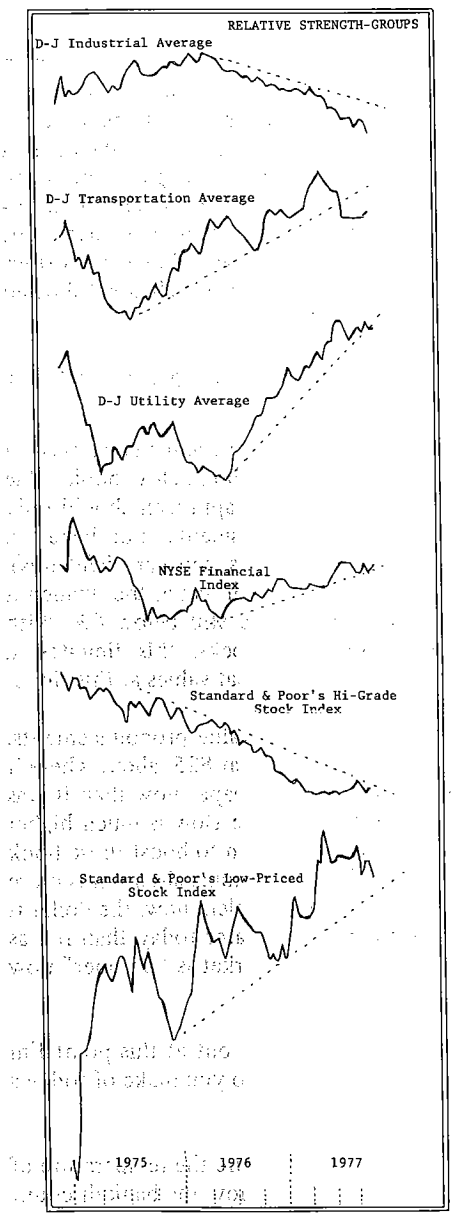
I have included six of my relative strength (RS) classifications on this semi-logarithmic chart (each RS ratio is entered on the chart at the beginning and the end of the month).

First, we have the D-J Industrial Average. Here the picture is clear enough. The Dow has been declining in RS since the second quarter of 1976. Furthermore, no change in this trend is yet evident on the chart.

The D-J Transports outperformed the market (I use the NYSE Composite Index for "the market") ever since mid-1975. During the second quarter of 1977, this trend in RS was reversed to the downside. RS in the carriers continues down as of this writing.

The D-J Utility Average has shown superior RS since mid-1976, and as you can see on the chart, the rate of climb in Utility RS has been spectacular. Over the past few months Utility RS has flattened out, but it is too early to tell whether it is to break decisively below its trendline and thereby reverse to the downside.

The NYSE Financial Index includes all the stocks on the NYSE which are financially oriented such as banks, S&L's, small loan companies, etc. This index has been rising in RS since the second quarter of 1976. Over the past month the Financials have been "walking the trendline."



The last two RS lines trace the action of S&P's High Grade Stock Index (an index of blue-chip issues such as Exxon, Ford, Proctor & Gamble, Sears, Xerox, GM, etc.) and S&P's Low Priced Stock Index. This is a very interesting comparison, and one that I want to comment on in a bit of detail.

Note that during the entire late-1974 to 1977 period, the High Grades have been dropping in RS, showing that investors were avoiding these stocks throughout the late bull market. On the other hand, RS in the Low Priced issues showed the biggest gains of any of the groups included on this chart. This makes me wonder whether I could have missed one of the most obvious manifestations of a bull market's third phase, and that is **speculation** and more particularly speculation in low priced stocks.

I had taken the position all through 1976 and early-1977 that we had never seen a bull market third phase. For this reason, I felt that following the 1977 decline, the third or final (speculative) phase of the bull market would materialize. In March and April I nevertheless advised my readers to get out of common stocks. And with the Transports' breaking of the 203.85 low on October 24, 1977, I stated that I believed a valid bear market signal had been given.

It is possible that my instincts were superior to my ability to observe. At any rate, it is clear on this chart that the RS in the Low Priced Index has advanced since late-1974 in the form of *three separate upward waves*. Could this be the "missing" frothy speculation which I was looking for, could the third advance in RS in the Low Priced Index represent the final period of speculative frenzy that I was waiting for? It could very well be. We may simply have seen an abbreviated primary bull market lasting from 1974 to late-1976 and early-1977, and we may have seen a subtle but legitimate third phase. That third phase might best be identified by the explosion in RS in the low priced stocks. Certainly, it is extraordinary that there would be such intense interest in the "cheapies" while interest in the better grade issues languished all through the 1975-77 period.

MONEY THOUGHTS: Each week a mountain of essays, statistics, graphs and analyses comes across my desk. I have been trying for about a month to synthesize these statistics into a series of usable facts. I read the various statistics and am increasingly flabbergasted. The only way I can put it is "What kind of a credit monster have we wrought?"

(1) Over the past 10 years America's banks have gone "multinational." The major US banks now derive about half their earnings from overseas. In their search for new clients, the banks zeroed in on the so-called "Less-Developed Countries," (LDC's). The best estimate I can come up with is that US banks have roughly $40 to $70 billion loaned out to the LDC's. The LDC's are now spending about 20% of their export earnings just to service their external debts. For some countries, Mexico and Brazil for instance, the amount is probably over 40%.

(2) It is increasingly doubtful whether some of these LDC's will ever be able to pay their debts off. The banks are therefore in the position of having to float new loans to some of these "overloaded" countries to stave off possible collapse. Moreover, in cooperation with the IMF, pressure is being brought on various LDC's to get their external accounts into balance via austerity. Unfortunately, austerity measures on already poor nations can topple the prevailing governments. Thus, the problems connected with the loans to LDC's are mounting.

(3) It is possible that political clashes will occur between the creditor nations and the LDC's. This presents a ghastly situation for the US, since US policy has been aimed toward backing the LDC's both morally and financially. The odds on "things going wrong" are growing. There is also a chance that the LDC's may band together and announce that they demand a "moratorium" on interest payments on their debt. This would be tantamount to mass default. The implications here are horrendous for US banks.

(4) On top of this, there is a staggering pool of dollars outside the US, which the IMF estimates at $350 billion (three times the

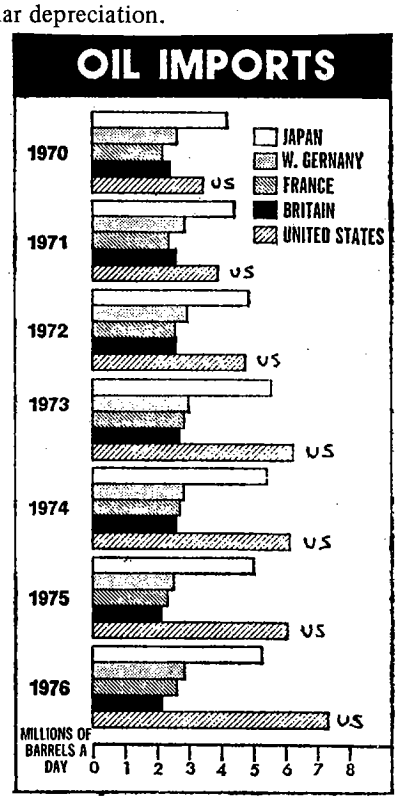
total which existed in 1973). There is also another $100 billion in short-term credit instruments which foreigners have invested in the US. In fact, it is estimated that foreign holdings will account for 23% of this year's US Treasury financing and 22% next year. The implications of this giant pool of foreign money residing here in the US are enough to make one grip his chair. For instance, foreign money in the US is very sensitive to dollar depreciation via inflation and to prevailing interest rates. If this foreign money sees a further (perhaps drastic) depreciation in the dollar, it could begin to pull out. The problems connected with such a pull-out would be mind-boggling.

(5) One immediate problem that would surface in case of a foreign pull-out of short-term assets would be that the Fed would have to turn to the American public for financing. Americans would have to purchase more Federal debt, and interest rates would rise to a level that would attract the public. A sudden run-up in interest rates would have adverse effects on the US economy.

(6) With European economies now sluggish or sliding (see last Letter), it is increasingly *difficult to export* US goods. Yet US *imports continue very high.* This year imports to the US will exceed exports by $30 billion! This is resulting in a further build-up of dollars in the hands of foreigners. As this process continues, the "price" of the dollar goes down. This vicious circle results in foreigners becoming increasingly frightened of the dollar, and they sell a part of their holdings, driving the dollar price down even further.

(7) In their effort to seek safety from the declining dollar and the gathering monetary storm, investors (and businessmen) have moved into various hard currencies such as the yen, the mark and the Swiss franc—and gold. Other money has moved into various "stores of value" such as real estate, gems, stamps, coins, etc. At this point, I feel that gold offers the best protection from further dollar depreciation.

(8) So far, I haven't mentioned the drain on the US stemming from our huge imports of oil. From an $8 billion oil bill early in the decade, the oil costs have now risen to $45 billion a year. Furthermore (see chart), oil imports show every sign of rising in the US. This is causing a huge build-up in Arab dollar reserves. Arabs have about $45 billion in the Eurodollar markets plus another $60 billion invested in the US. Thus, the potential for an Arab retreat out of the dollar is huge. The only thing that stops the Arabs from fleeing the dollar now is (a) they have too big a stake in world prosperity, and (b) there is no other repository large enough to take the place of the sliding dollar—although, of course, they can diversify to some extent.



(9) The loss of value in the dollar is of great concern to the Arabs, and they are at the point where they have to **do something** about it. In the OPEC meeting next month, I therefore expect either a new boost in the price of oil or a demand for gold clauses in new sales of oil.

(10) A final comment is that last week the US reached a milestone. We now have $700 billion in debt, up from $600 billion last year! Any sane man can see that this compounding of debt **cannot go on.**. But how do you stop a car when it's going around a curve at 100 mph? Ah, that may be what the current bear market is all about.

U.S. Debt Reaches Historic $700.1 Billion

WASHINGTON — The federal debt surpassed $700 billion for the first time yesterday in the Treasury Department's daily financial statement.

The Treasury said the goverment owed $700.12 billion at the most recent tally last Thursday. The debt passed the $600 billion mark only last year.

On Oct. 4, Congress raised the temporary ceiling on the national debt from $700 billion to $752 billion. Without the periodic extension, the limit on the debt would revert to $400 billion.

Question: What do you make of the high volume that appeared directly after the November lows?

Answer: As I've stated in previous reports, I never like high volume unless it appears following the bettering of important preceding peaks. I also stated that the high volume in early November seemed almost like "an advertisement" for the coming "monster move upwards." My friend Marty Zweig presents some of his excellent research in his latest report. He tabulated statistics on 16 previous clusters of high-volume days (two days each) during bear markets. In every case, these volume explosions turned out to be part of the topping action which was followed in due time by new lows in the Averages.

Question: What do you make of everyone saying that stocks are now cheap? Is this a valid observation?

Answer: On the basis of book value, the Dow and a great mass of stocks are now "cheap," since they are selling below book value and far below replacement value. But this approach should only be used together with other value assessments. For instance, you can't put book value in the bank (as you can dividends). And speaking of dividends, another test of value, the dividends on the Dow, at the November lows were still below 6%. With bonds still yielding 2-3% **more** than stocks, this time-tested approach throws doubts on stocks being great values at this time.

One has to be very careful about simple value pronouncements. For instance, in April, 1964, the Dow was at 825, about where it is now. I ask myself, is the Dow really cheaper now than it was 13 years ago? True, the book value of the Dow is much higher today, but we have had 13 years of inflation to boost those book values. Taxes are higher today, the international situation is more difficult, we have a horrendous energy problem now, the dollar is weaker, and foreign competition is far greater today than it was in 1964. On this basis, I wonder if the market is "cheaper" now than it was back in 1964.

Question: I hear a lot about money rates, but at this point I'm getting immune to the whole thing. What do you make of today's money rates?

Answer: The prevailing interest rates measure the temperature of the monetary patient. For instance, right now the bank discount

rate is 6%. (It was raised to 6% on Oct. 25, 1977). I am indebted to research from *Hoenig & Strock*, Federal St., Boston, Mass) for the following research. Few people realize that in the history of the Federal Reserve System, there were only five previous cases of a 6% discount rate.

The *first* 6% rate came on November 14, 1914, following a major market decline, and during the period when the stock market was closed due to World War I. The *second* 6% rate occurred in January, 1920. By mid-1921 the Dow had dropped 50%. The *third* boost to 6% came on August 9, 1929. No comment is needed on that one. The *fourth* came on April 4, 1969. Over the next 14 months the Dow declined 31%. The *fifth* 6% instance occurred on May 11, 1973. Over the next 17 months the Dow declined 36%.

The conclusion is that a 6% discount rate is **unusual** and it has **bearish implications** for the market and the economy. A 6% discount rate is an indication of prevailing weakness in the economic structure.

Question: I note that on your page 1 chart and in all your analyses, you always use the *closing* price of the D-J Averages. What about the daily highs and lows?

Answer: The daily high and low "prices" are actually the peaks and lows that "would have occurred" if all the stocks in the Average hit the daily high (or low) extremes at the same time. Thus, these highs and lows are theoretical, not actual. The Dow Theory is only interested in the final or closing price. The theory behind this is that specialists, traders and speculators might manipulate the price action during the day, but these men often "clean the books" before the close. Thus, the closing price represents the market minus the in-and-out traders and potential manipulators.

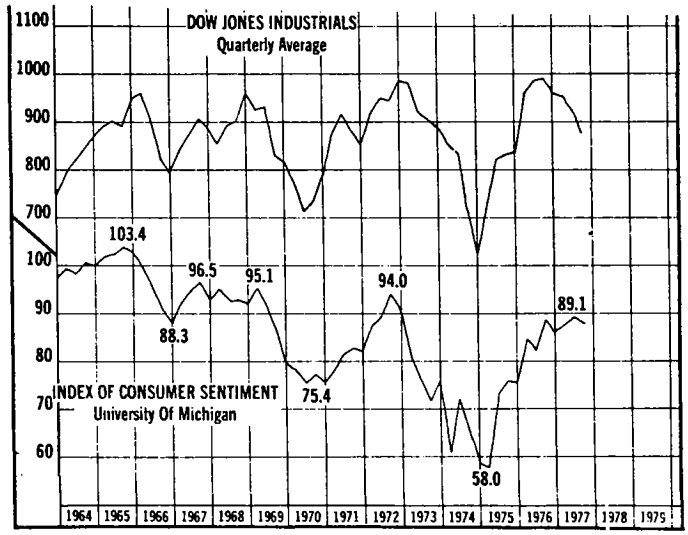
Question: In the past you discussed many individual stocks. Why have you stopped?

Answer: I try to place the emphasis where I think it belongs. I have been bearish on the primary and secondary trends of the market, and therefore I believe the emphasis should be placed on attempting to keep my subscribers out of common stocks. Secondary emphasis is placed on trying to locate the next profitable bottom or "trading buy spot." Least emphasis is placed on individual stocks. We don't need 'em now.

Question: You keep talking about *sentiment* in the Letters. How do you use sentiment in your studies?

Answer: The basis for all market sentiment studies is the time-honored observation that "***the majority is seldom correct in the market–and if correct, never correct for long.***" I use a large number of sentiment studies including odd lot trends, members' transactions, short interest trends, mutual funds purchases-to-sales, psychology in newspaper headlines, advisory service sentiment, etc. The last named is used extensively in this business, not because advisers are stupider than anyone else, but because a reading on 20 to 30 advisories can be easily taken every week or so.

Bill Bretz, editor of the excellent new *Juncture Recognition* report (Box 1209, Pompano Beach, FL 33061), has just presented a fascinating sentiment study, the Dow vs. the University of Michigan Consumer Sentiment Index. Normally, says Bill, consumer sentiment and stock prices have a long-term



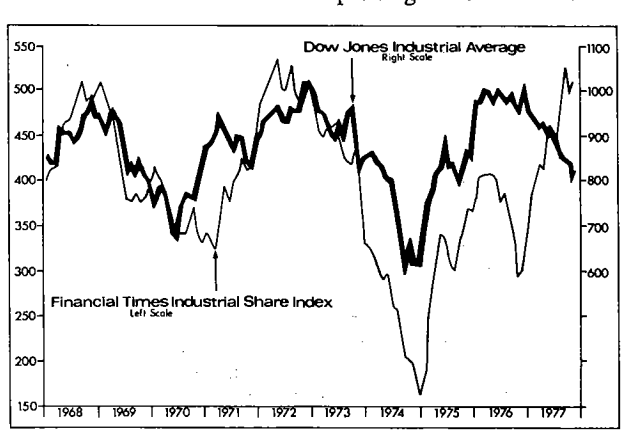
influence on each other. And the chart does show this interesting correlation. But in the recent 214 point decline in the Dow, consumer sentiment has **stayed bullish**. Says Bretz, "*The market has never fallen so far in an atmosphere of such total unconcern . . . . I can't help but wonder how far down the Dow will have to go in order to produce the kind of fright that is the hallmark of an important market bottom.*"

Question: Are Treasury bills safer than the so-called "liquid assets" or money funds?

Answer: In my opinion, yes. Although the liquid asset funds are largely in short-term debt instruments, many of them hold large amounts of bank certificates of deposit and commercial paper. A smaller amount is in lower-yielding T-bills. Thus, the majority of their holdings are **within the banking system.** This is all right as long as the banking system is all right. But for absolute safety one should be outside the banking system. This means Treasury obligations and gold. Capital Preservation Fund, 459 Hamilton Ave., Palo Alto, CA 94301, is a liquid asset fund which is entirely in T-bills but the payout here is low, under 5%. So I come back to the two safest investments, T-bills which are the number one obligation of the US Government, and "true money" or gold.

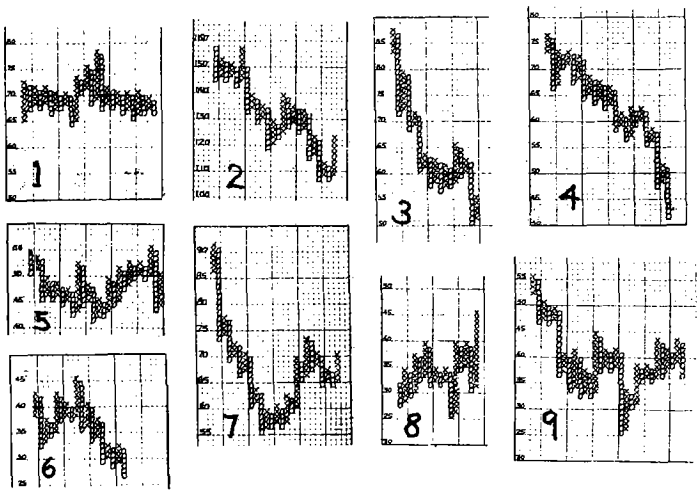
Question: You have written in the past about the inter-relationship between the US and the British market. What do you see in that relationship now?

Answer: Historically, the US market has tended to *bottom out* before the British market (because the US was the stronger economy). And the British market has tended to *top out* before the US market (because the British was the weaker market). The 1976-77 period, however, may see a rare cross-up. The chart shows the British market exploding almost to its old high



during 1977–even while the Dow is heading down. Many observers felt that Britain was leading the way and that the US market would surely follow. So far, that has certainly not happened.

Moreover, the British market is now turning down, as if following the Dow to lower levels. Ironically, the US market may be the leader for a British top this time. Why is this? Probably because the dollar is now weaker than the pound, and large interests have been selling US stocks for over a year (whereas selling in England started only a few months ago). Chart is courtesy of Acorn, Chart House, Church St., Godalming, Surrey, England.



STOCKS: The market has turned "hodge-podge" with all sorts of cross-currents, the most outstanding being weakness in the "biggies" and strength in the secondaries. I have included 9 representative P&F charts (courtesy of CMI, 1122 N. Camano Dr. Camano Island, WA 98292). I've numbered each chart, and I think it's interesting to see what we have here.

For instance, chart No. 1, bellwether GM, looks as if it's forming a top with a drop into the 63-64 area completing the top. Another bellwether (No. 2), DuPont, has formed a little double bottom in the 106 area, following its earlier collapse. Even if DD has bottomed out, it looks like it would take a good deal more "work" and consolidation to turn it bullish. Kodak, chart No. 3, has actually broken below its 1974 low. The stock should hit tremendous resistance in the 56 area. EK would require a much bigger bottom than it has now–if it's to start a new bull trend. The last of the Dow stocks (No. 4), Union Carbide, has plunged to an incredible 42 level. No start of a bottom here, and buyers of UK here are simply shooting craps.

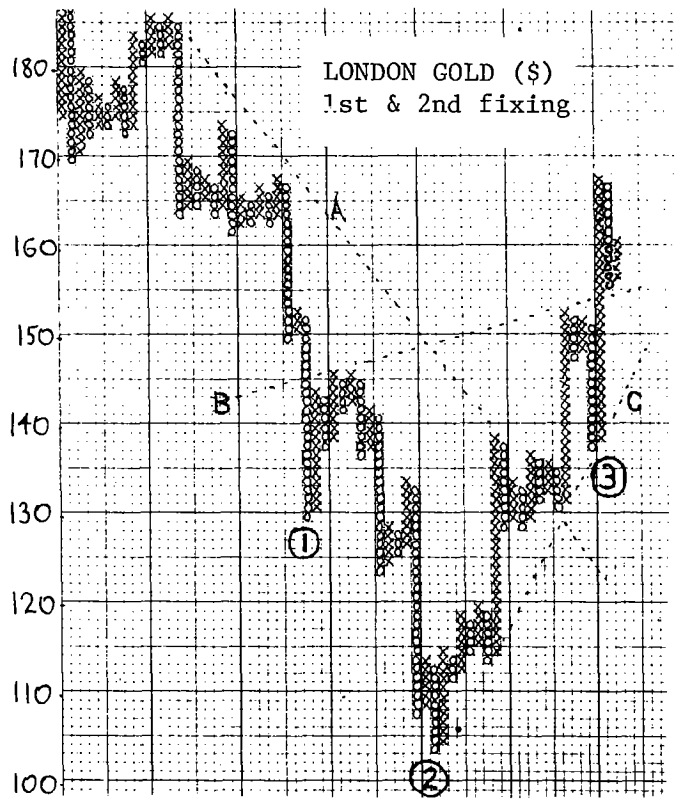
Glamor stock Honeywell (No. 5) could be trying to form a large bottom in the 41-45 area. HON is coming back to test the low 40's, and it could have seen its low. Polaroid (No. 6) seems to be losing downside momentum, but there's no bottom here yet. On the other hand, Burroughs (No. 7) does seem to have hit a bottom in the 55-60 area. Strong support at 64 and again at 56. Bausch & Lomb (No. 8) is an outright good-looking chart, and I'd be surprised if this stock hadn't seen its bear market low. Finally, Homestake (No. 9) looks surprisingly bullish on the chart.In fact, the chart looks better than the daily action of HM would leave us to believe. HM should have very strong support at 35. What we see in HM is a large head-and-shoulder base, but it will take 46 to break HM out of this base.

So that's it, a varied lot, but I wouldn't be a buyer unless the "market" itself looked right. In my book, it just doesn't–which means that buyers don't have the odds with them (and believe me, in this business you need those odds).

GOLD has always been a "good acting" chart subject (very few deceptive moves). I stated in the last report that gold could drop down to the 155-56 area just above trendline B, at which point it would be a "buy." Gold got down to 156.15 on Nov.22, then pushed up. On Nov. 28 gold popped 3.50 to 161.50, and I think that completes the correction. With a little more work, maybe one more dip, gold should try for the 1977 high area at 168 and maybe push to over-170 territory.

Note on my chart that if gold can consolidate in the 162-174 area, it could be building an even more massive "head-and-shoulders" bottom with the new breakout point slated to be above 175. At any rate, gold appears to be building very impressive long-term support at the above-150 level.

The US just came out with a shocking statistic–it's October trade deficit was $3.1 billion, worst October in US history. Part of this was due to a 15% drop in US exports. In the last Letter I showed how all the foreign stock exchanges were heading down, thereby predicting a slump in Europe and Japan. That's beginning to show up in our export figures. Foreigners are cutting back on their imports from the US, and that's bearish for the dollar.



LATE NOTES: I've just read this week's advisory services, plus *Barron's*, and the almost unanimous opinion is that "the rally will continue" with many saying "a major advance" in the offing. I don't see it. My statistics show that the A-D ratio has been up 12 out of the last 15 days or up 80% out of the last 15 trading days. That makes the market short-term over-bought in my book. Despite all this upside breadth, **Dow 845.89** has still not been bettered. Whoever is selling the big Dow stocks isn't kidding around, and they don't care if every $5 number on the NYSE heads higher, they want to get out of the Dow stocks. I've felt ever since late-1976 that the Dow was telling the true story, and I still feel that way.

If the Dow 845.89 level can't be bettered and soon, then I see this as a dangerous market, and I don't care if every analyst in the nation thinks this market is going to 1000.

NEXT MAILING: December 9th